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COMMENT

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Tax Changes and Corporate-Owned Life Insurance

The income tax rules with respect to the taxation of life insurance policies are changing effective January 1, 2017. Both individually-owned and corporate-owned policies issued, acquired or converted after 2016 will be subject to the new tax regime.

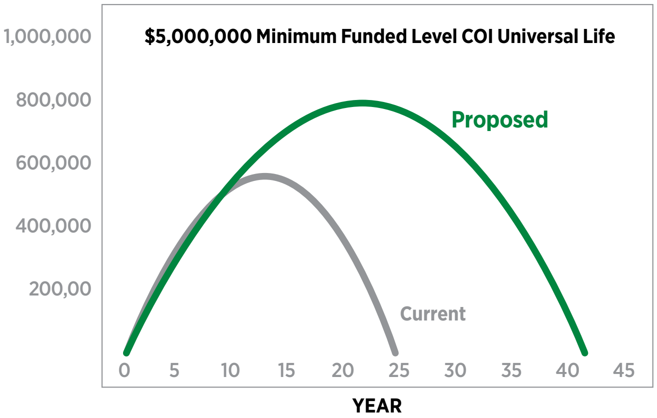
Some of the changes will have a significant impact on the taxation of corporate-owned life insurance policies. For example, the formula to calculate the adjusted cost basis (ACB) of a life insurance policy will reflect a smaller net cost of pure insurance (NCPI).

The NCPI is calculated by multiplying the mortality factor from the prescribed mortality table by the "net amount at risk". Both of these elements are being reduced under the new rules.

The prescribed mortality factors are now based on an updated actuarial table which reflects the trend to longer lifespans resulting in reduced mortality factors. At the same time, the new rules will define the "net amount at risk" to be the difference between the death benefit and the new reserve for the policy. The old rules allowed for the deduction of either the cash value of the policy or the old policy reserve (which was generally smaller than the new reserve) from the death benefit as the measure of the net amount at risk.

A smaller mortality factor, and a smaller net amount at risk, results in a much smaller net cost of pure insurance. Since the NCPI is deducted in the formula for the ACB, this results in a higher ACB.

The following graph highlights the impact of a smaller NCPI amount on the ACB of an insurance policy issued to a male age 45, non-smoker.



A large ACB is good if the policy owner is going to do a full or partial surrender of the contract as it results in a smaller policy gain. On a full surrender of a life insurance policy, a policy gain is recognized to the extent the cash surrender proceeds are greater than the ACB of the policy. In addition, a large ACB is beneficial if the policyholder is going to take a policy loan since a policy gain only results from that portion of the loan in excess of the policy's ACB.

A large ACB is also of benefit when a policy owner decides to take dividends in cash. A cash dividend reduces the ACB of the policy and only when the ACB is completely eroded does a policy gain get recognized.

On the other hand, a large ACB can be seen as a negative for corporate-owned life insurance because of its impact on the capital dividend calculation. A private company is entitled to credit its capital dividend account (CDA) by an amount equal to life insurance proceeds received in excess of its ACB in the policy. Amounts credited to the CDA can be distributed as tax-free capital dividends to the shareholders. (Exception: US citizens living in Canada would be taxable on capital dividends when filing their US returns.) To the extent the ACB is larger and remains positive longer, the CDA credit will be smaller.

The most important item to note is that changes to the tax regime will not change the role life insurance plays in meeting the financial needs associated with an individual's death. Life insurance should continue to be an important part of every Canadian's portfolio for managing against financial risks. And, as long as a policy qualifies as an exempt policy, proceeds payable at death remain tax free.

I/R 7401.01

New Insights Into The Value Of Pension Plans

Employer-sponsored pension plans contribute to the financial security of employees in their retirement years, yet a recently released study by Statistics Canada shows participants gain even more than the obvious benefit of "forced" savings. The study shows that pension plan members far exceed their non-pension-participating peers in overall wealth accumulation, even when wealth is counted without inclusion of the pension assets.

The significant variance in wealth when comparing pension participants and non-participants is quite astounding. The study looked at families and single people where the major income recipient was aged 30 to 54 and employed as a paid worker. Those in the study had no significant business equity in their employer.

Those who do not participate in employer-sponsored pension plans have access to registered retirement savings plans (RRSPs) to which they can contribute roughly an equivalent amount. There is a general sense that non-plan members would or should accumulate wealth in RRSPs and non-registered plans to compensate for the lack of pension assets. The question often arises as to whether participating in a pension plan increases private savings or simply redistributes the savings.

In 2012, the median net worth of pension families in the study was over three times greater than their non-pension peer group, even when pension assets are excluded. Pension families had median net worth of $210,600 compared with $64,000 for non-pension families. Adding pension assets into the mix places the pension families at $353,140 compared with the $64,000 for non-pension families. Of interest is the median net worth for defined benefit (DB) pension families as it relates to different employment sectors. For example, non-public service DB plans show a median net worth of $292,989 whereas the amount grows significantly to $473,394 for those in a DB plan in public administration. These variances are not new as this same pattern was evident in the comparable 1999 analysis.

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RPP members are more likely to have employment tenure of 10 or more years, be married and have a greater after-tax income than their non-pension peer group. As an observation, the longer term employment tenure could be viewed as a proxy for more stable and larger after-tax income leading to a higher net worth.

The study found that the pension families are 50 per cent more likely than their non-pension peer group to have RRSP/locked-in retirement account (LIRA) assets, 60 per cent more likely to own a principal residence, and 20 per cent more likely to own a vehicle. These numbers are more than simply a wealth consideration but extend into behavioural observations as to how the two groups tend to manage their financial affairs. Pension families are 50 per cent more likely to have a mortgage or other debt. As an observation, this makes sense in that there is a reasonable correlation between home ownership and a mortgage.

The study uncovers a plethora of new insights that suggest "forced" savings result in greater wealth even when pension assets are removed from the picture. This suggests that participation in a pension plan creates behaviours that lead to a greater propensity to save.

I/R 5401.00; 6851.00

New Tax Measures

A number of tax proposals introduced in the 2015 federal budget, together with previously announced tax measures, were included as part of Bill C-59 which received first reading in the House of Commons on May 7, 2015. The breadth and number of changes are noteworthy because of the broad groups of taxpayers who are affected.

Taken directly from the Department of Finance's May 7, 2015 news release, below is an overview of the many tax and related measures contained in the Bill:

- Reducing the small business tax rate to 9 per cent by 2019; lowering taxes for job-creating small businesses and their owners by $2.7 billion between now and 2019–20.
- Providing manufacturers with a 10-year accelerated capital cost allowance to encourage productivity-enhancing investment in machinery and equipment.
- Increasing the Lifetime Capital Gains Exemption to $1 million for owners of farm and fishing businesses.
- Extending the Mineral Exploration Tax Credit until March 31, 2016.
- Improving access to financing for Canadian small businesses through the Canada Small Business Financing Program.
- Increasing the Tax-Free Savings Account annual contribution limit to $10,000, effective for 2015 and subsequent years.
- Implementing the Family Tax Cut, a federal tax credit that will allow a higher-income spouse to, in effect, transfer up to $50,000 of taxable income to a spouse in a lower tax bracket, effective for the 2014 tax year.
- Increasing the Universal Child Care Benefit (UCCB) for children under age 6. As of January 1, 2015, parents are eligible for a benefit of $160 per month for each child under the age of 6 - up from $100 per month.
- Expanding the UCCB to children aged 6 through 17. As of January 1, 2015, under the expanded UCCB, parents are eligible for a benefit of $60 per month for children aged 6 through 17.
- Increasing the Child Care Expense Deduction dollar limits by $1,000, effective for the 2015 tax year. The maximum amounts that can be claimed will increase to $8,000 from $7,000 for children under age 7, to $5,000 from $4,000 for children aged 7 through 16, and to $11,000 from $10,000 for children who are eligible for the Disability Tax Credit.

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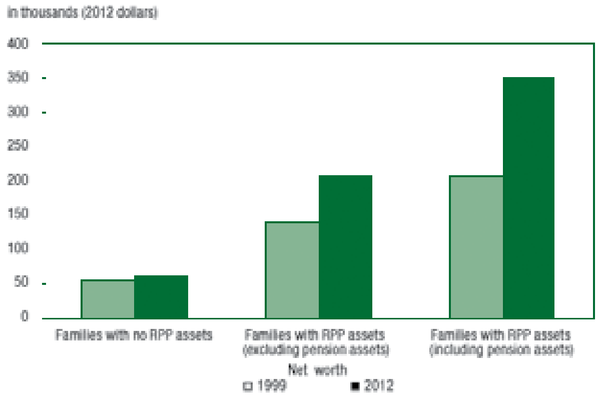
- Reducing the minimum withdrawal factors for Registered Retirement Income Funds to permit seniors to preserve more of their retirement savings to better support their retirement income needs.
- Supporting seniors and persons with disabilities by introducing the Home Accessibility Tax Credit to help with renovation costs to make their homes safer and more accessible, so that they can live independently and remain in their homes.
- Ensuring veterans and their families receive the support they need by: providing a new Retirement Income Security Benefit to moderately to severely disabled veterans; expanding access to the Permanent Impairment Allowance for disabled veterans; and creating a new tax-free Family Caregiver Relief Benefit to recognize caregivers.
- Extending Employment Insurance Compassionate Care Benefits from six weeks to six months to better support Canadians caring for gravely ill and dying family members.

These measures are considered to be "substantially enacted" as of May 7, 2015 allowing businesses to recognize their impact in their accounting records. Also, the Canada Revenue Agency has announced that it is administering a number of these measures as if they are already enacted.

A number of these issues will be explored in future editions of this publication.

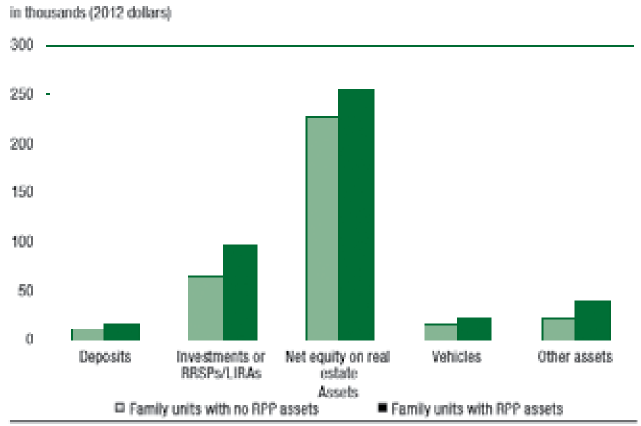
I/R 7401.01

Chart 1
Median net worth, families with and without RPP assets, 1999 and 2012



Notes: Includes family units where the major income recipient is aged 30 to 54 and employed as a paid worker. Family units with business equity of $1,000 or more (in 2012 dollars) are excluded.
Source: Statistics Canada, Survey of Financial Security, 1999 and 2012.

Chart 2
Average asset values, families with and without RPP assets, 2012



Notes: Includes family units where the major income recipient is aged 30 to 54 and employed as a paid worker. Family units with business equity of $1,000 or more (in 2012 dollars) are excluded.
Source: Statistics Canada, Survey of Financial Security, 2012.

Source of Chart 1 & 2: Insights on Canadian Society, Employer pension and the wealth of Canadian families, Statistics Canada, January 15, 2015

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